Internal Revenue Service

memorandum

CC:TL:Br3
PScott-Clayton

date: AUG 17 1988

to: District Counsel, San Francisco W:SF

from: Director, Tax Litigation Division CC:TL:Br3

subject: [redacted] Credit for Increasing Research Activities

Introduction

You have requested our views as to the entitlement of the taxpayer, [redacted], to the Credit for Increasing Research Activities under I.R.C. § 44F (1954 Code) (as applicable to the years in issue) attributable to the exercise of non-statutory stock options by its employees for taxable periods [redacted]-[redacted].

Issues

1. Whether the payment of wages attributable to the exercise of non-statutory stock options by the taxpayer's employees is a "qualified research expense" within the meaning of the I.R.C. § 44F(b), Credit for Increasing Research Activities.

2. Whether the Credit for Increasing Research Activities under I.R.C. § 44F is applicable to wages paid pursuant to the exercise of non-statutory stock options granted prior to the enactment of I.R.C. § 44F.

Conclusions

1. The payment of wages attributable to the exercise of the non-statutory stock options by the taxpayer's employees is not a "qualified research expense" within the meaning of the I.R.C. § 44F(b), Credit for Increasing Research Activities.

2. The Credit for Increasing Research Activities under I.R.C. § 44F is not applicable to wages paid pursuant to the exercise of non-statutory stock options granted prior to the enactment of I.R.C. § 44F.

Background

According to the Revenue Agent's Report (RAR), the taxpayer adopted its first stock option plan in [redacted]. This was approximately [redacted] years before the taxpayer's initial public offering of stock in [redacted]. Options granted under this plan were to expire [redacted] years after they were granted. The option prices granted under the [redacted] plan were extremely low in reference to the market price of the stock after the company went public and particularly in reference to the market price of the stock during the [redacted] through [redacted] years which are at issue in this case. The [redacted] option prices were as low as [redacted] per share.

In [redacted], the [redacted] Stock Option Plan was terminated and was replaced by the [redacted] Stock Option Plan. The policy of pricing the options at market prices when granted continued, but these options were due to expire [redacted] years after grant date or [redacted] days after the employee's separation from [redacted], whichever came first. As of [redacted], the taxpayer reported there were options for [redacted] shares of stock under the [redacted] and [redacted] plans. As of that date, [redacted] had been exercised and [redacted] remained unexercised.

The [redacted] Stock Option Plan was terminated in [redacted] 1980 and replaced by the [redacted] Stock Option Plan. As of [redacted], [redacted] options had been granted, but none were exercised. On [redacted], the average purchase price of the [redacted] outstanding options for all [redacted] option plans was $[redacted] per share.

In [redacted], all outstanding options with a price in excess of $[redacted] per share were repriced to that amount to recognize the current market value of [redacted] stock. On [redacted], a similar repricing action set the maximum option price at $21.875 per share. On [redacted], it was reported that there were [redacted] outstanding options with prices ranging from [redacted] cents to $[redacted]. On [redacted], the taxpayer reported that [redacted]% of its outstanding options had a price of $[redacted] per share or greater.

The exercise of the above-described options, which are "non-statutory stock options", was a common form of compensation for the taxpayer's employees. Options were granted when an employee joined the firm as well as in recognition of meritorious accomplishments. As the market price increased with reference to the option price, the employee would exercise the option and often sell the stock immediately for a quick profit. The difference between the market value and option price paid by the employee was required to be included in the ordinary income

of the employee at the time of exercise. The taxpayer withheld income taxes in relation to this income when the options were exercised. It was common for the taxpayer, after issuing the stock, to immediately sell it on the employees' behalf and remit the net proceeds after withholding of taxes to the employee. The income from the bargain element of the options exercise and the required withholding were reported on the employee's Form W-2 wage statement for the year. The amount included in the employee's income was deducted by the taxpayer.

In addition to non-statutory stock options, the taxpayer also claimed deductions resulting from its employees' disqualifying dispositions of stock acquired through the incentive stock option program and the employee stock purchase plan. Under these plans, the employee did not recognize taxable income upon receipt of the stock, but if the employee disposed of the stock prior to the expiration of a statutory holding period, he would be required to include in income the difference between the sales price and the option price (with some minor exceptions). The amount included in the employee's income was deducted by the taxpayer.

For the years at issue, the following amounts were claimed as expenses subject to the I.R.C. § 44F Credit for Increasing Research Activities as a "qualified research expense":

Nonqualified Option Exercise	$[redacted]	$[redacted]	$[redacted]
Disqualifying Dispositions			
Incentive Stock Options Employee Stock Purchase Plan	[redacted]	[redacted]	$[redacted]
Total	$[redacted]	$[redacted]	$[redacted]

The Revenue Agent stated in the RAR that "qualified research expenses" should relate to services performed within the tax year of the credit. RAR, p. 286. The Revenue Agent further stated that Congress did not intend to apply the credit to a form of compensation that would substantially increase without a corresponding increase in research activity. RAR, p. 287.1/

1/ The agent also argued in the alternative that the exercise of the option did not represent an expense "paid or incurred" by the taxpayer. RAR, p. 288. We did not address this alternative argument since under our position the expenses are not allowable even if they were "paid or incurred."

The taxpayer's response to the RAR was that qualified wage expenses are not limited to services performed currently. The taxpayer argues quite strongly that the wage expense arose in the year the options were exercised, not in the service years. In rejecting the view that Congress intended for wages attributable to service in earlier years to be ineligible, the taxpayer stated:

> [P]repaid contract expenditures excluded under Sec. 44F(b)(3)(B) are still qualified research expenses; they just get shifted to the subsequent year.. Congress most likely did not enact an equivalent rule for wage expenses because, unlike contract expenses, wages are typically post-paid, not prepaid. Taxpayer Memo., p. 7.

The taxpayer speculated that Congress "may have been protecting the revenue" by not requiring that the wage expenses be claimed for services performed currently for purposes of the credit. Taxpayer Memo., p. 7.2/

Discussion

The Credit for Increasing Research Activities was first enacted by Section 221 of the Economic Recovery Act of 1981 and appeared as Section 44F of the Internal Revenue Code of 1954 (hereafter "Section 44F"). The credit was originally to expire on December 31, 1985. Section 417(c) of the Tax Reform Act of 1984 redesignated Section 44F as Section 30. The Tax Reform Act of 1984 did not amend the credit provisions substantively. Section 231 of the Tax Reform Act of 1986 redesignated Section 30 as Section 41. The Tax Reform Act of 1986 extended the credit to amounts paid or incurred before January 1, 1989, amended the definition of qualified research for taxable years beginning after December 31, 1985, provided a separate credit with respect to certain payments to qualified organizations for basic research, and amended the credit provisions in certain aspects. Since the taxable periods at issue are years [redacted], Section 44F is the version of the Credit for Increasing Research Activities applicable to the instant case.

2/ We believe that the taxpayer has missed the entire point of the prepaid contract research rule which is to ensure that research expenses are treated as paid or incurred in the taxable "period in which the research is conducted." I.R.C. § 44F(b)(3)(B); Proposed Reg., § 1.44F-(2)(e)(4).

Section 44F(a) allows a credit for increasing research activities. The credit is available for a specified portion of a taxpayer's qualified research activities. The Conference Agreement on the credit lists the credit for increasing research activities under the section entitled, "Incentives for Research and Experimentation." S. Conf. Rep. No. 176, 97th Cong., 1st Sess. 223 (1981).

Section 44F provides, in pertinent parts, as follows:

(a) General Rule. There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to 25 percent of the excess (if any) of -

(1) the qualified research expenses for the taxable year, over
(2) the base period research expenses.

(b) Qualified Research Expenses. - For purposes of this section-

(1) Qualified research expenses. - The term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer-

(A) in-house research expenses, and
(B) contact research expenses.

(2) In-house research expenses. -

(A) In general - The term "in-house research expenses" means -
(i) any wages paid or incurred to an employee for qualified services performed by such employee,

* * *

(B) Qualified services. - The term "qualified services" means services consisting of -
(i) engaging in qualified research, or
(ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

> If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirements of clause (i) or (ii), the term "qualified services" means all of the services performed by such individual for the taxpayer during the taxable year. [Emphasis added].

Reviewing the above relevant portions of I.R.C. § 44F, "qualified research expenses" include amounts paid or incurred for "in-house research expenses", which is in turn defined as including wages paid or incurred for "qualified services." Since "qualified services" are limited to services consisting of qualified research or the direct supervision or support of qualified research activities performed for the taxpayer "during the taxable year," "qualified research expenses" are limited to wages paid or incurred for services performed during the taxable year. I.R.C. §§ 44F(b)(1), (b)(2)(A)(i) and (b)(2)(B). With certain exceptions not relevant here, Section 44F(b)(2)(D) limits the scope of the term "wages" to the definition of wages set forth in I.R.C. § 3401(a).3/

In the instant case, many of the stock options exercised in taxable periods [redacted] were granted years before they were exercised. In fact, the most lucrative options, priced under $[redacted], were granted well before the Credit for Increasing Research Activities was enacted. These options were granted when the employees were hired, or for meritorious services performed during [redacted] through [redacted], if not earlier. In all cases, the options were granted for either current or past services. None of the options were exercised in the same year they were granted. As previously stated, "qualified services", by definition, are limited to services performed within the taxable year. Since the

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3/ We do not dispute the taxpayer's basic position that the exercise of the non-statutory options results in a wage expenditure within the meaning of I.R.C. § 44F(b)(2)(D). The difference between the market value and option price paid by the employee is required to be included in the ordinary income of the employee at the time of exercise. Treas. Reg. §1.83-7. This income is wages within the meaning of I.R.C. § 3401(a) in the year the option is exercised. Rev. Rul. 67-366, 1967-2 C.B. 165. We believe that a factual issue exists, however, as to whether each employee to whom the options at issue were granted was performing qualified research services at the time they received the options. For example, if [redacted] granted the option to an employee in the marketing department and then transferred that employee to the research department, the later exercise of the option would not result in qualified research expenses.

wages with respect to the exercise of all of the non-statutory stock options at issue were for services provided in years prior to the options' exercise, they were not paid for "qualified services." Hence the taxpayer may not claim the I.R.C. § 44F credit for any of the wages expenditures at issue.

The purpose of the credit is to encourage taxpayers to increase their qualified research activities. The legislative history indicates that the amount of the credit was to bear a direct relationship to the increase in amount of qualified research expenditures on a year-by-year basis:

> Under the Act, a non-refundable income tax credit is allowed for certain qualified research expenditures paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer (new Sec. 44F). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specific base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount. Joint Committee, General Explanation of Tax Act of 1981, (hereafter "General Explanation"). H.R. 4242, Pub. L. No. 97-34, 97-34, 97th long., 1st Sess. p. 121.

Congressional objectives for the Credit for Increasing Research Activities were clearly intended to limit the credit to expenses directly attributable to increasing research activity:

> Because of difficulties for taxpayers and the Internal Revenue Service in distinguishing research expenditures from nonresearch expenditures, and <u>in order to limit the credit to principal types of research expenditures which distinctly reflect the extent of increased research activities</u>, the credit is limited to certain direct wage, supply, and equipment research expenditures (or a specified percentage of contact research expenditures). The credit is not allowed for other types of research expenditures, or for indirect, administrative, or overhead expenditures. General Explanation, <u>supra</u>, p. 120. Emphasis added.

The fact that the credit has a sunset provision further reflects Congressional concern that the credit would continue to be available only if it actually, in fact, stimulated increased research activity. The legislative history provides as follows:

> The new credit for certain incremental research expenditures expires after 1985. Accordingly, the

> Congress will have an opportunity to evaluate the operation and efficacy of the new credit.
>
> For example, the Congress will be able to evaluate whether the credit operates to stimulate additional research expenditures, or simply rewards increased research expenditures which would have been made in the absence of a credit; whether the categories of qualifying research expenditures should be broadened or narrowed; whether the taxpayer and the Internal Revenue Service have been able to accurately to distinguish qualifying research expenditures from nonqualifying research-related expenditures, such as indirect, overhead, or administrative wage expenditures, and from nonresearch expenditures, such as costs of market research, quality control, or production; whether the base period computation rules are appropriate; and whether the restrictions and limitations on the availability and use of the credit . . . have been effective to accomplish Congressional intent. General Explanation, supra, p. 121.4/

If the instant taxpayer was allowed to claim the bargain element from the exercise of the non-statutory stock options as a qualified research expenditure, Congressional intent would be thwarted. If a company's stock price were to accelerate rapidly and increase the bargain element of the options, a substantial credit could be generated even if the research staff and salaries remained absolutely level. In fact, the research activity could even decrease with the stock option compensation on the rise and this certainly would not meet the intention of Congress in terms of encouraging research and increasing innovation. RAR, p. 287.

The denial of the credit in the instant case does no injustice to the taxpayer. Congress was aware that certain research expenditures which are deductible under I.R.C. § 174

4/ Significant changes were made in the credit under the Tax Reform Act of 1986 which were consistent with this criteria. See I.R.C. §§ 41(d)(3) and (4) of the 1986 Code. Specifically, I.R.C. § 41(d)(4)(A) states that post-production phase research expenses are not eligible for the credit. Such expenses represent expenditures which would have been made in the absence of the credit. Similarly, the wage expenditures at issue would arguably have been paid or incurred in the absence of the credit since a substantial portion of the options were granted before the credit was even enacted.

would not qualify for the Credit for Increasing Research Activities.

> While the definition of research generally is the same for purposes of both sec. 174 deduction elections and the new credit, particular research expenditures which qualify for the sec. 174 deduction elections may be ineligible for the credit, e.g., because the expenditures do not fall within the categories of research expenditures (such as direct wages) which qualify for the credit, or because the expenditures fall within one of the exclusions from the credit. General Explanations, supra, p. 123-124, n. 5.

Thus, Congress fully envisioned that certain research related expenses which qualify for the Section 174 deduction would not be eligible for the Section 44F credit.

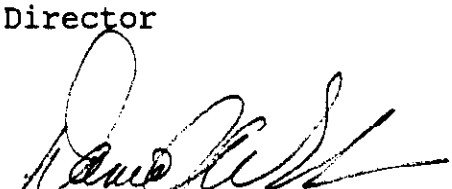
To allow the credit to apply in this instance would violate the intent of the statutory scheme which requires expenditures to be calculated on a year-by-year basis. See I.R.C. § 44F(a) (credit limited to 25% of the excess of qualified research expenses over base period expenses); I.R.C. § 44F(c) (base period research is the average of qualified research expenses for each year of the base period). By artificially inflating the current year's research expenditures while at the same time artificially deflating the base period expenditures, the amount of the credit is vastly increased with no corresponding increase in research

activities. Such a result is not supportable under any reasonable reading of the statute and legislative history. Therefore, the position in the statutory notice of deficiency denying the credit under I.R.C. § 44F in full should be sustained.5/

Even if the court should find that the wages paid on the exercise of non-statuary stock options were "qualified research expenses," the credit would not be available to the extent the options were granted prior to the enactment of I.R.C. § 44F. Under no circumstance should the credit for increasing research activity be available where there is absolutely no way to show that the credit served as either an incentive for granting the option or for increased research. Non-statutory options granted before July 1, 1981 would fall into this category.

Sincerely,

MARLENE GROSS
Director

By: 
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5/ The taxpayer's position with regard to the disqualifying exercise of incentive stock options, to the extent granted in years prior to its exercise, is equally not sustainable in light of our position on the primary issue. However, additional grounds for rejection of this position are contained in Rev. Rul. 71-52, 1971-1 C.B. 278, which provides that income realized on the disqualifying disposition of qualified stock options are not "wages" under I.R.C. § 3401. Section 44F(b)(2)(D) defines "wages" for purposes of the credit as having the same meaning as "wages" under I.R.C. § 3401.